No. 17-1077

In the Supreme Court of the United States

FRANCIS V. LORENZO,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

REPLY BRIEF FOR PETITIONER

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ARGUMENT

This case is an appropriate vehicle to resolve the question presented, which has been properly preserved and presented to this Court.

I. The SEC Does Not Dispute that the Circuits Are Split on the Question of Whether an Inadequate Claim for Misstatement Liability Can Be Repackaged as a Scheme Claim

The Securities and Exchange Commission (SEC or Commission) does not dispute that the circuit courts are split regarding the central question presented in this petition, namely whether a misstatement that does not meet the threshold for misstatement liability under Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. 78j(b)(2006)(the "Exchange Act") and SEC Rule 10b-5(b) 17 C.F.R 240.10b-5(b) can be repackaged as a fraudulent scheme claim under Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. 77q(a)(1)(2006) ("Securities Act") and Rule 10b-5(a) and (c), 17 C.F.R. 240.10b-5(a) and (c). As Petitioner's brief in support of this petition for certiorari noted, the circuits have split 3-2 on this question (Pet. 17-20). The Second, Eighth and Ninth Circuits have held that a misstatement alone cannot be the basis of a fraudulent scheme claim, while the DC Circuit and the Eleventh Circuit have held that a misstatement standing alone can be the basis of a fraudulent scheme claim. (Pet. 17-21)

The Commission attempts to paper over the circuit split by arguing that the circuits are not split on the scope of liability under Section 17(a)(1) of the Securities

Act (Brief for the Respondent in Opposition ("Opp.") at 8). However, merely because the circuit courts are not split with regards to Section 17(a)(1) of the Securities Act does not mean that the critical question of the scope of liability under Section 10(b) and Rule 10b-5(b) should not be resolved by the Court. The question regarding the scope of liability under this provision is an important and recurring question.

II. The Decisions that Petitioner Cites Reflecting the Majority Position Do Not Involve Different Conduct than the Conduct at Issue Here

The SEC argues that the circuit court cases Petitioner cites regarding the majority position are distinguishable because the cases supposedly involve different conduct than what is at issue here. (Opp. 8) However, the SEC's argument is mistaken. For example, *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005) involved misstatements that are identical in character to the alleged misstatements in this matter in the sense that the statements in the *Lentell* case conveyed to investors a very positive assessment of the underlying investment. "The scheme had five elements common to research published on 24/7 Media and Interliant: (i) "the public issuance and maintenance of knowingly or recklessly false, bullish research reports"; (ii) the publication of false "BUY or ACCUMULATE recommendations" on 24/7 Media and Interliant; (iii) the setting of "profoundly unrealistic price targets for [those] stocks"" (*Lentell*, 296 F.3d at 165).

The SEC next argues that the Eighth Circuit's decision in *Desai v. Deutsche Bank Sec., Ltd.*, 573 F.3d

931, 939 (9th Cir. 2009) can be distinguished from this matter because the *Desai* decision "addressed whether a putative class was entitled to the presumption of reliance under [*Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972)]" (Opp. 19 n.5) However, the SEC's argument has the analysis in *Desai* backward because the *Desai* Court had to first determine whether a fraudulent scheme case could be repackaged as an omission case before the court could reach the issue of whether a presumption of reliance could be had by the plaintiffs. "The presumption of reliance under *Affiliated Ute* is limited to cases that "can be characterized as . . . primarily alleg[ing] omissions." Therefore, if Investors' putative class action is not such a case, they cannot avail themselves of the *Affiliated Ute* presumption." (*Desai*, 573 F.3d at 940).

In fact, the *Desai* Court never had to reach the issue of whether a presumption of reliance could be had by the plaintiffs because the court determined that a scheme case could *not* be repackaged into a misrepresentation or omission case. Likewise, the conduct in *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039 (9th Cir. 2011) case is very similar to the conduct at issue here in that it involved alleged misrepresentations and omissions made to investors regarding material information about the company they were investing in. The plaintiffs in the *WPP* case alleged that the "[d]efendants carried out a plan, scheme and course of conduct which was intended to and did deceive WPP into continuing to invest in and support [Spot Runner] by concealing from WPP that the Founders of the Company and other Defendants were selling off their shares in large quantities." (*WPP*, 655 F.3d at 1057)

The *WPP* Court found "[a] defendant may only be liable as part of a fraudulent scheme based upon misrepresentations and omissions under Rules 10b-5(a) or (c) when the scheme also encompasses conduct beyond those misrepresentations or omissions." (*Ibid.*)

Contrary to the SEC's argument, the Ninth Circuit's decision in *Public Pension Fund Group v. KV Pharmaceutical Co.*, 679 F.3d 972 (8th Cir. 2012) is also on point because it involved misrepresentations made by the defendant to investors concerning material information about a company's business, including false and misleading statements about earnings. The *KV Pharma* Court held that a scheme liability claim must be based on conduct beyond just misrepresentations and omissions. The *KV Pharma* Court stated:

> Both the Second and the Ninth Circuits have held "[a] defendant may only be liable as part of a fraudulent scheme based upon misrepresentations and omissions under Rules 10b-5(a) or (c) when the scheme also encompasses conduct beyond those misrepresentations or omissions." *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057 (9th Cir.2011); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005) ("[W]here the sole basis for such claims is alleged misrepresentations or omissions, plaintiffs have not made out a market manipulation claim under Rule 10b-5(a) and (c)[.]"). We join the Second and Ninth Circuits in recognizing a scheme liability claim must be

> based on conduct beyond misrepresentations or omissions actionable under Rule 10b-5(b).

KV Pharma, 679 F.3d at 987.

III. Federal Court Holdings in Private Lawsuits Regarding the Elements of Antifraud Claims Also Apply to SEC Enforcement Actions

The SEC argues in opposition to the petition that the cases cited by Petitioner to demonstrate the circuit split have arisen out of suits by private plaintiffs rather than SEC enforcement cases. (Opp. 8). However, this argument is without merit because the same legal standards govern the adequacy of claims under the antifraud provisions of the federal securities laws whether the claims are brought by the SEC or brought by private plaintiffs. In fact, it is undisputed that the standards set out by the Court in *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. 13 (2011) for claims under Section 10(b) of the Exchange Act and Rule 10b-5(b) apply to SEC enforcement claims even though the *Janus* decision involved private litigation. Moreover, neither the majority nor the dissent in the court below ever argued that the cases from the Second, Eighth and Ninth Circuits (constituting the majority position) were inapplicable to this matter because those cases arose from private actions. Finally, the SEC's argument that the holdings in private lawsuits do not apply to SEC enforcement actions is particularly misplaced because throughout its opposition brief the SEC cites numerous decisions in private litigation when discussing the elements of claims under the federal antifraud provisions of the federal securities laws. (Opp. 8 - 15)

IV. The Commission Relies Primarily on Case Law that Predates the *Janus* Decision

The Court in *Janus* established a bright-line test to determine whether a person can be liable for false statements under Section 10(b) of the Exchange Act and Rule 10b-5(b) thereunder. In *Janus*, this Court held that a defendant can be liable for false statements under Rule 10b-5(b) only if the defendant was the "maker" of the false statements. *Janus*, 564 U.S. at 142. The Commission's argument that the decision below is consistent with *Janus* is incorrect. In its opposition the Commission discusses a number of cases that stand generally for the proposition that different provisions of the federal securities laws may overlap are not necessarily mutually exclusive. (Opp. 11- 12) However, the vast majority of the cases the SEC relies on predate the *Janus* decision and the few cases that the SEC cites that have come after *Janus* conflict with the position taken by a majority of the courts of appeals.

V. The SEC's Arguments Concerning the PSLRA Are Not Relevant

As discussed above, the Second, Eighth and Ninth Circuits have each held that a misstatement standing alone cannot be the basis of a fraudulent scheme claim. The Commission attempts to distinguish the decisions from the Second and Ninth Circuits by arguing that they involved cases that were brought by private plaintiffs and the cases were subject to the Private Securities Litigation Reform Act of 1995 ("PSLRA") Pub. L. No. 104-67, 109 Stat. 737. The PSLRA states that "if an allegation regarding the statement or omission is made on information and belief, the

complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. 78u-4(b)(1). However, none of the decisions cited by Petitioner when discussing the circuit split turn on the application of the PSLRA. In fact, neither the majority nor the dissent in the court below addressed the PSLRA in any way in their analysis of the various circuit court decisions addressing whether a defective misstatement claim can be repackaged as a scheme claim. Further, the SEC's argument regarding the PSLRA is misplaced because in this matter Petitioner is not challenging the adequacy of the Commission's fraud allegations as contained in the SEC's Order Instituting Proceedings, which is analogous to a complaint in federal court.

VI. Scheme Liability Was Not Presented as a Theory of Liability in Lorenzo's Administrative Proceeding

The SEC's attempt to impose scheme liability on Petitioner is particularly unfair, and constitutes a violation of his due process rights, because scheme liability was not a theory of liability that was pursued by the SEC in the administrative hearing. In fact, the administrative law judge's finding that Petitioner violated the antifraud provisions of the federal securities laws is based entirely on the theory that he made misrepresentations. The Administrative Law Judge found that "[t]he record shows that Frank Lorenzo violated the antifraud provisions *by making material misstatements and omissions in the emails*." (Pet. App. 113)(emphasis added) and "([i]n sum, it is concluded that Frank Lorenzo willfully violated the antifraud provisions of the Securities and Exchange Acts *by his material misrepresentations and omissions*

concerning W2E in the emails." (Pet. App. 114) (emphasis added).

The first time that a theory of scheme liability is raised is not at the administrative proceeding where Lorenzo had a chance to present testimony and other evidence but in the Commission's decision on appeal. "We also find that Lorenzo employed a "device, scheme, or artifice to defraud," in violation of Section 17(a)(1) and Rule 10b-5(a); that he engaged in an "act" that would operate as a fraud in violation of Rule 10b-5(c); and that his conduct was deceptive, as required by Section 10(b)." (Pet. App. 77)

As noted in Judge Kavanaugh's dissent below, the Commission's finding that Lorenzo's conduct amounted to a fraudulent scheme "was done without hearing from Lorenzo or any other witnesses" and that "the Commission simply swept the judge's factual and credibility findings under the rug." (Pet. App. 41). In this case, "the Commission rewrote the administrative law judge's factual findings to make those factual findings correspond to the legal conclusion that Lorenzo was guilty and deserving of a lifetime suspension." (*Ibid.*) The conduct by the Commission in this case denied Petitioner his right to a fair hearing (Pet. App 49) and the Commission should not be permitted to impose scheme liability on Lorenzo.

VII. The Question Presented is Critically Important and Properly Presented

The Commission also argues that this matter is allegedly in an interlocutory posture and this constitutes sufficient grounds for the Court to deny the petition. (Opp. 20) This argument is wrong for several

reasons. First, there is no bar to the Court's jurisdiction. The Court's jurisdiction in this matter is invoked under 28 U.S.C. § 1254(1) which provides "[c]ases in the courts of appeals may be reviewed by the Supreme Court by the following methods (1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree. . ."

Second, the DC Circuit has already issued a *definitive and final ruling* on the issue that is the subject of this petition for certiorari, namely the DC Circuit held that a defective misstatement claim under *Janus* can be repackaged as a scheme claim and brought under Section 17(a)(1), Section 10(b) and Rule 10b-5(a) and (c). By so holding the DC Circuit deepened an already existing split in the circuits. It is also noteworthy that the DC Circuit did *not* remand this matter to the Commission for additional fact finding and, in fact, the Commission has confirmed that there will be no additional fact finding when it issued its order requiring only legal briefs regarding sanctions be filed with the Commission itself. (*In re Lorenzo*, Securities Act Release No. 3-15211, 2017 WL 6349871 (Dec. 12, 2017). The Commission is not reopening the record or taking any additional testimony nor is it conducting a new hearing before an administrative law judge. The only issue that is pending before the Commission is what sanctions are to be imposed on Lorenzo for violations of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5(a) and (c). Regardless of how the Commission determines that sanctions issue the central holding of the Commission and the DC Circuit regarding Lorenzo's underlying violations of

Section 17(a)(1), Section 10(b) and Rule 10b-5(a) and (c) will not be changed.

In these circumstances this Court should grant the petition for a writ of certiorari. "[W]here there is an important and clear-cut issue of law that is fundamental to the further conduct of the case and that otherwise would qualify as a basis for certiorari, interlocutory status need not preclude review." *Randolph Cent. Sch. Dist. v. Aldrich*, 506 U.S. 965 (1992) (White, J., dissenting from denial of certiorari) (citations and internal quotation marks omitted).

Finally, the Court's jurisprudence under a different jurisdictional statute, 28 U.S.C. § 1291, is instructive here because the "Court has held that the requirement of finality is to be given a "practical, rather than a technical, construction." *Gillespie v. United States Steel Corp.*, 379 U.S. 148 (1964) citing *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541, 545 (1949). Therefore, appealable finality is not limited just to matters where a judgment or order completely terminates a case. In *Gillespie*, this Court decided to hear an appeal because the Court's consideration of the inconvenience, cost and delay that would be involved if the appeal were denied all weighed in favor of the Court hearing the appeal. Similarly, here the SEC's argument that this matter should not be heard until the Commission imposes its sanctions and Petitioner again appeals to the DC Circuit and then files a new petition seeking a writ of certiorari is the very definition of inconvenience, cost and delay, particularly when the central legal issue regarding the applicability of scheme liability to Lorenzo has already been decided.

As discussed in the petition for a writ of certiorari the question presented in this petition arises frequently in SEC enforcement proceedings and in private securities litigation, including securities class action lawsuits. (Pet. 21) Private litigation and SEC enforcement actions often involve very significant liability and, in addition, SEC enforcement actions (like the one filed against Lorenzo) often seek to bar individuals from working in their chose profession in the securities industry.

The question presented in this case is of national importance, both for the SEC's enforcement program as well as for private plaintiffs. The question will reoccur and likely lead to a deepening of the circuit split if the Court does not grant Lorenzo's petition. In fact, federal district courts in circuits that have not ruled on the issue raised in this petition have already taken conflicting positions. *Compare Lautenberg Found. v. Madoff*, 2009 WL 2928913, at *12 (D.N.J. Sept. 9, 2009)("[c]ourts have generally held that '[a] Rule 10b–5(a) and/or (c) claim cannot be premised on the alleged misrepresentations or omissions that form the basis of a Rule 10b–5(b) claim'") *with SEC v. Benger*, 931 F. Supp. 2d 904, 905-06 (N.D. Ill. 2013) (misstatements can give rise to liability under the antifraud provisions even if the conduct in question does not amount to "making" a statement under *Janus*). *See also SEC v. Familant*, 910 F. Supp. 2d 83, 93-95 (D.D.C. 2012)(holding that misstatements can give rise to liability under the antifraud provisions even if the conduct in question does not amount to "making" a statement under *Janus*). The conflicts between the circuits and the disparate treatment of defendants based on what circuit they happen to be in

will only continue and grow more pronounced if the Court does not decide the important question presented in this petition.

CONCLUSION

For the foregoing reasons and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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